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SUBJECT: Argentina Economic and Financial Weekly for the week ending
July 7, 2006

Weekly Highlights

- CPI increases 0.5 percent m-o-m in June -- below market expectations. PPI up 0.8 percent m-o-m.
- Venezuela joins Mercosur.
- The GOA renews its request for budgetary "superpowers."
- The GOA further loosens the beef export ban.
- Argentina and Venezuela to issue a bi-national "Southern Bond."
- Banco Nacion will be forced to finance the GOA.
- Commentary of the Week: "Toward a renovation of the financial system"

CPI rises 0.5 percent m-o-m in June -- below market expectations.
PPI rises 0.8 percent m-o-m.

¶1. The Consumer Price Index (CPI) increased 0.5 percent m-o-m in June, below market expectations of 0.7 percent, and follows an identical increase in May. The better-than-expected result is due mainly to reduced pressure on food prices, which represent almost one-third of the Index. Last month's increase brought inflation to 4.9 percent in the first half of the year, compared to a 6.1 percent increase in the same period last year. CPI core inflation was up 0.6 percent, and the seasonal component of the index increased 0.4 percent, while the regulated component increased just 0.2 percent. The categories with the highest price increases were housing (+0.8 percent), home supplies and maintenance (+0.7 percent) and other goods and services (+0.7 percent). Meat prices (representing 4.5 percent of the consumer basket) decreased -1.4 percent m-o-m due to price restraint agreements between the GOA and the meat sector as well as the partial ban on beef exports. Year-on-year, CPI increased 11 percent. The BCRA consensus survey forecasts 11.5 percent inflation in 2006, down from last month's forecast of 12 percent. The 2006 budget projects a 9.1 percent inflation rate for 2006, and the Central Bank's inflation target range is 8-11 percent.

¶2. Producer prices increased 0.8 percent m-o-m in June, due to a -0.3 percent decrease in primary goods prices and a 1percent increase in the prices of manufactured goods prices and electricity.

The price of imported goods increased 2.4 percent. The PPI index increased 12.2 percent y-o-y.

Venezuela joins Mercosur.

¶3. Venezuela was officially welcomed into Mercosur on July 4 but, although Venezuela now has a voice in the organization, it does not yet have a vote. Venezuela's full incorporation will occur only after the four member countries (Argentina, Brazil, Paraguay and Uruguay) send their legislatures' approval to the Latin America Integration Association (ALADI). After that notification, Venezuela will have four years to adopt Mercosur's external tariffs and its common nomenclature and rules. The Mercosur block's next goal is to incorporate Bolivia.

Venezuela reportedly will buy USD 1.8 billion of Boden 2012 bonds through the end of the year.

¶4. According to local media, the GOV will buy approximately USD 1.8 billion of Boden 2012 from the GOA by the end of the year. The schedule calls for the purchase of USD 200 million of Boden 2012 every 20 days. These funds will be used to strengthen the BCRA's reserves; the GOA's goal is to reach USD 28 billion in reserves by the end of the year (the BCRA's reserves are currently at USD 25 billion).

Argentina and Venezuela announce they will issue a bi-national "Southern Bond."

¶5. Argentina and Venezuela also announced that they will release a bi-national "Southern Bond" in the next 90 days. In that period, the GOV will designate an international bank to release the bond in the international market. Because Venezuela's debt rating is higher than Argentina's, the GOA expects to receive a 1.5-point reduction in the bond's interest rate compared with the rate that it would pay on a regular bond issuance. Argentina will issue the bond, and Venezuela will provide capital and interest warranties in case of default.

The GOA renews its request for budget "superpowers."

¶6. On June 29, the GOA sent a bill to the Congress that would modify the Financial Administration Act and the Fiscal Responsibility Law and give the GOA so-called "superpowers" over the national budget. The proposal would give the GOA the power to modify the Budget Law and give the Chief of Cabinet the power to reallocate funds irregardless of the provisions of the Financial Administration Act or the Fiscal Responsibility Law. These "superpowers" were requested in the 2006 budget, but Congress did not approve them. The GOA also has asked for suspension of article 15 of the Fiscal Responsibility Law, which sets a maximum limit on discretionary spending and prohibits budgetary changes that cause an increase in current expenses relative to capital expenses. The GOA's intention is to consolidate control of federal resources in the executive branch, relegating Congress' role to validating the total budget figures, without interfering in spending decisions. The bill has been approved by the Senate's Constitutional Affairs Committee and will be debated in the Congress on July 12.

The GOA further loosens the beef export ban.

¶7. The GOA issued a new resolution stating that exports of hindquarter cuts weighing more than 460 kilos (1,012 lbs) and of beef used in canned products will be permitted for 60 days, with a possible 30-day extension, depending on how this measure affects domestic prices. The GOA partially lifted the near-total ban on beef exports beginning June 1, allowing exporters to sell 40 percent

of the amount of beef they had exported from June to November of 2005. Economy Minister Felisa Miceli said that "at this time, conditions are ripe for opening exports further since demand fell after exports were suspended, causing prices to drop in the corresponding categories."

Banco Nacion bank will be forced to finance the GOA.

18. A presidential decree has modified the capitalization regime for GOA-owned Banco Nacion (established in the 2006 budget). Decree 811/2006 states that during the next three years, Banco Nacion will receive five-year bonds indexed by CER (a CPI-linked index) instead of cash contributions from the GOA. Through this change, the GOA will have ARP 1.9 billion extra at the end of 2008 and will close the 2006 fiscal year with USD 300 million left over. The GOA justified this move as being due to insufficient expected budgetary resources. Banco Nacion is the largest bank in Argentina.

Banks prepaid more discount borrowings to the BCRA.

19. Banks canceled another USD 126 million in discount borrowing to the BCRA, which implies a monetary absorption by the BCRA of a similar amount. Since last year, banks have been prepaying their debt with the BCRA, mostly acquired during the 2001 economic crisis. During the last 18 months, banks have cancelled 68 percent of their loans and the number of banks with outstanding discount debt fell from 24 to 3 (Galicia Bank, Provincial Bank of Buenos Aires and Bisel). Banks are rushing to repay their debt because it is indexed to CER (a CPI linked index) plus a 3.5 percent annual rate. Taking the relatively high inflation into account, this represents a heavy financial burden for the banks.

Food companies leery about revealing their cost structure to the GOA.

110. Food companies are evaluating whether they will reveal their cost structures to the GOA. Secretary of Internal Trade Guillermo Moreno said last week that those food companies that want to discuss price adjustments should present a detailed report of their cost structure for every product and the increase they are planning to make. Food companies agreed to this because they feared that the GOA otherwise would apply the Supply Law to them (which gives the GOA the power to establish maximum prices and penalties). However, some multinational companies are prohibited by their headquarters from revealing their production costs, because of the strategic value of this information to their competitors.

May trade surplus of USD 1.3 billion -- the highest in the last two years and above expectations.

111. The May trade surplus reached USD 1.3 billion, above market expectations of USD 1.2 billion. Growth of both exports and imports accelerated with respect to April. Exports increased 13 percent y-o-y to USD 4.1 billion, a new historic record, following 8 percent y-o-y growth in April, with increases in both price (+7 percent) and quantity (+6 percent). Exports were driven by increases in industrial goods (+34 percent y-o-y), agro-industrial products (+20 percent y-o-y) and decreases in fuel and energy (-3 percent y-o-y) and primary goods (-7 percent y-o-y). Imports increased 14 percent y-o-y to USD 2.8 billion, accelerating after April's 7 percent y-o-y increase, with increases in both quantity (+13 percent) and price (+1 percent). Imports were driven by increases in accessories for capital goods (+10 percent), passenger vehicles (+38 percent), consumer goods (+39 percent), capital goods (+30 percent) and intermediate goods (+7 percent), and a decrease in fuel and oil (-31 percent). The accumulated trade surplus reached USD 5 billion during 2006 and, according to the BCRA consensus survey, it is expected to narrow to USD 9.9 billion at the end of the year

compared to USD 11.3 billion in 2005.

The GOA will eliminate double severance pay in case of layoffs at the end of the year.

¶12. Following President Kirchner's announcement that May unemployment decreased to 9.8 percent, the GOA is analyzing whether to eliminate so-called double severance pay in case of layoffs (which is actually 150 percent of the monthly salary for each year the employee has worked). The GOA will wait for the official unemployment figures -- expected to be published in August by the National Bureau of Statistics (INDEC) -- before eliminating double severance pay, but private companies are already asking for a quicker determination. The double severance pay rule was instituted at the height of the 2002 economic crisis and is defended by labor union leaders who are willing to let it go only in exchange for an increase in the minimum wage from ARP 630 to ARP 850.

The BCRA slows monetary expansion.

¶13. During Q2 of 2006, the BCRA started to decelerate its monetary expansion to keep it in line with the goals set in its 2006 Monetary Program. In the first six months of the year, the BCRA absorbed ARP 13 billion, 65 percent through anticipated cancellation of discount lending and public sector operations. According to preliminary information, the growth rate of M2 -- money held by the public plus sight deposits -- slowed by more than 3 percent points compared to March.

¶14. The BCRA is also slowing its purchases of euros. In June, the BCRA bought only EUR 2 million, the lowest acquisition since the BCRA entered the euro market in January in an attempt to diversify its portfolio. Argentinean investors have shown little interest in the currency because of the lack of liquidity on the Argentine market.

June labor demand index up 7.18 percent m-o-m.

¶15. The June labor demand index calculated by Di Tella University increased 7.18 percent m-o-m to 112.91 points, the index's second increase in 2006 after a 1.04 percent increase in April. So far this year, labor demand has decreased 1.03 percent. The increase is mainly due to rising demand for technical employees (+15.49 percent), commercial personnel (+14.2 percent) and professionals (+12.56 percent). The index is up 7.6 percent y-o-y. [The index is based on comparisons of job vacancy announcements printed in the two largest newspapers of the country.]

BCRA rolls over its maturities. Investors concentrated their bids in Nobacs.

¶16. The BCRA received ARP 1.4 billion in bids at its July 4 Lebac and Nobac auction, compared to ARP 1.1 billion in Lebacs that came due during the week. ARP 475 million came from the fixed peso segment and ARP 638 million from the pesos indexed by CER segment. It accepted ARP 506 million in Lebac bids and ARP 858 million in Nobac bids. The yield on the 70-day Lebac decreased from 7.25 percent to 7.10 percent, the 168-day Lebac decreased from 8.60 percent to 8.50 percent, and the yield on the 252-day Lebac decreased from 10.20 percent to 10.18 percent. The yield on the longest term instrument, the 336-day Lebac, remained at 12 percent. Lebacs for maturities of more than 336 days were withdrawn due to lack of interest. The spread on the one-year Nobac remained in 2.03 percent and decreased from 3.72 percent to 3.74 percent for the two-year Nobac. The Badlar rate (the base rate for Nobacs) is currently at 9.1 percent. Investors reversed their tendency towards Lebacs and concentrated their bids in Nobacs; this was a response to the BCRA's downward movement in the Lebacs yield and to a high Badlar rate.

The peso is unchanged against the USD this week, closing at 3.10
ARP/USD.

¶17. The peso remained flat versus the USD this week, closing at 3.10 ARP/USD. On Wednesday, the BCRA purchased USD 112 million, a 10-month record, to keep the peso unchanged against the USD. In the first four days of the week, the BCRA purchased USD 179 million. The peso exchange rate has depreciated 1.6 percent since the beginning of the calendar year. The BCRA's reserves stood at USD 25.8 billion as of July 5, and have increased USD 6.8 billion, or 36 percent, since the GOA prepaid its entire IMF debt on January 2.

Commentary of the week: "Toward a renovation of the financial system", by Fabio Rodriguez -- Executive Director of Fundacisn Capital -- from an article published in Cronista Comercial on June 15.

¶18. There is currently a wide consensus about the need to strengthen the current economic growth cycle (which is entering its fifth year of expansion) by regenerating deeper credit channels, especially for medium and long-term credit. As demand pressures spread and many sectors reach the limits of their installed capacity, favoring the largest investments through a financial system that completely fulfills its role as a creditor has become a priority.

¶19. Despite the significant expansion of financial activity (which for the second consecutive year will make a positive contribution and increase at a faster rate than GDP), levels of financial intermediation are still lower than pre-crisis levels (e.g. 1997 or 2000). In light of this evidence, those who stress a glass-half-empty outlook toward the recovery point out that the ratio of credit-to-GDP barely rose in the last two years, from 7 percent to just 10 percent, and that it is still very low with respect to the 23 percent ratio before the crisis. They also emphasize that the core of re-intermediation is concentrated in the

short-term and that many activities are supporting the generation of internal liquidity for investment and growth. Finally, they also point out that a large part of the improvement in the system's performance has come from the strong macroeconomic environment (the low real interest rate is the most frequently mentioned, which reduces the cost of collecting and increases returns).

¶20. While still recognizing these points as true in general, I will put forward some arguments in favor of recognizing a set of improvements that have led to a post-crisis financial system that has a very solid foundation and is able to facilitate economic growth. More than anything, it is worth highlighting that financial development, measured as a ratio of credit-to-GDP, is not in itself a policy variable, but rather the complex result of the process of financial intermediation. Several factors come together and interact, from the macroeconomic and institutional environment and the regulatory and enforcement capacity, to the behavior of depositors, banks, investors and other actors that demand financing. As you will note, several of these aspects are beyond the control of policy makers.

¶21. Concerning assets, their structure is changing, favoring the recovery of credit to the private sector, a persistent decrease in the banks' exposure to the public sector, and an increase in liquidity (including Lebac and Nobac holdings). After reaching nearly 50 percent at the worst point of the crisis, loans to the public sector fell to 40 percent by the end of 2004, and to 29 percent today. A public sector with a structural surplus, the right regulatory moves by the Argentine Central Bank that put limits on banks' exposure to the Treasury (holding to a limit of no more than 40 percent of assets by the end of 2006) and many entities' own decision to reduce their holdings of government securities all favor the crowding-in of the credit market.

¶22. With respect to liabilities, the normalization of the funding structure continues to show improvement. Banks' debt to the Central

Bank (BCRA discount lending to improve banks' liquidity during the crisis) is decreasing and the share of deposits (in banks' balance sheets) is increasing. Thanks to diverse mechanisms from 2005 to today, among which anticipated cancellation of discount loans stands out, financial entities paid back around ARP 12 billion (in terms of capital).

¶23. In terms of net worth, what stands out is the increase in solvency of the system thanks to new capitalization (which total around ARP 7.5 billion since 2004) and the generation of positive results since 2005. (After registering accumulated losses of more than ARP 25 billion between 2002 and 2004, the consolidated system produced profits near ARP 2.8 billion for 2005 and the first quarter of 2006.)

¶24. It is also worth mentioning various measures that help to avoid new currency mismatches (given that banks are no longer permitted to lend dollars to clients who can only repay in pesos) and which contribute to strengthening the global solvency of the system even more, given that by pesifying their balance sheets, banks became less vulnerable to movements in the exchange rate.

¶25. Up to this point, favorable trends indicate a healthy improvement in financial entities' balances and various measures that constitute an improved regulatory platform. All this contributes to predicting a financial system that, without repeating the mistakes of the recent past, has a pro-growth orientation directed to the needs of productive sectors, and not to the niche of easy gains from financing the public sector on the backs of the private sector (which was the logic that operated from 1998 to 2001).

¶26. Of course, the challenges and difficulties that remain are even more important when considering financial development that not only translates into deeper credit in the economy, but also in a jump in its quality. Today, financing relies primarily on consumption and on businesses' short-term labor capital, while financing of medium and long-term investment remains scarce.

¶27. This brings us to a crucial challenge for Argentina, which focuses on cutting the Gordian knot that supposes that it is impossible to generate channels of savings and credit in pesos and for the long-term. The platform of consistent macroeconomic policy

is a fundamental pre-condition for generating confidence in the medium-term. From a regulatory point of view, the pattern is positive given that, as we saw, a financial system is emerging with a favorable balance of risks. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

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